BEFORE THE STATE OF WASHINGTON
ENERGY FACILITY SITE EVALUATION COUNCIL

IN RE APPLICATION NO. 99-1

SUMAS ENERGY 2 GENERATION FACILITY

EXHIBIT _____ (RK-T)

APPLICANT'S PREFILED TESTIMONY

WITNESS : RICHARD KEEFE

Q. Please state your name and business address.

A. Richard Keefe

Macquarie Corporate Finance (USA) Inc.

600 Fifth Avenue

New York, NY 10020

Q. What subjects will you address in your testimony?

A. First, I will describe my background.

Second, I will explain how power projects of this sort are typically financed.

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Third, I will address how substantial regulatory requirements, such as the greenhouse gas offset requirement advocated by some parties in this case, can affect the ability to obtaining financing for a project.

Background & Experience

Q. What is your current position?

A. I am a Division Director for Macquarie Corporate Finance (USA) Inc. Macquarie is a full range, old style investment bank – we provide advice and assistance to enable parties to complete complex financial transactions. My particular group deals in asset based transactions, and more particularly, I work in the U.S. energy infrastructure area. My group assists in the sale, purchase, and/or financing, of generating facilities in the United States and Canada.

Q. Can you describe your educational background and experience?

A. I have a BA in Economics from Rice University, a JD from Columbia Law School, an MBA in Finance from Columbia Business School, and an LLM in Taxation from NYU Law School. From 1975-1990, I worked for the law firm of Dewey Ballantine, working mainly on transactions – buy, sell, lease, finance. I became a partner at Dewey in 1985. In 1990, I joined a small boutique investment bank, Fieldstone Private Capital Group. There, I concentrated on energy project financial transactions. In 1999, I joined Macquarie, again concentrating on the financing of U.S. energy projects. A copy of my resume is provided as Exhibit ____ (RK-1).

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Q. How many power projects have you been involved in financing?

A. Since 1985, I have probably been involved in over 100 energy facility transactions. Most recently, in the West, I have worked on eight sales of generating facilities in California, the sale of a developed project in Washington, the lease of a plant in California, the development of two plants in Nevada, the sale of a facility in Idaho, the financing of two proposed transmission lines interconnecting to the Pacific Northeast, the purchase of a transmission line in Alberta, the sale of two plants in Canada, and the purchase of a facility in Northern California, as well as investigating numerous other potential transactions.

Q. Have you provided expert testimony before?

A. Yes – twice. Once, in litigation in Delaware, in the context of a sale of an energy facility, on what an investment banker does, how and why potential investors are solicited, the methodologies used, and the time and trouble it takes to successfully conclude a deal. Second, in California, in a tax case on the proper valuation of an energy facility.

Financing Power Projects

Q. Can you explain in general terms how projects of this type are usually financed?

A. There is no one universal answer to financing. There is really no "usual." Basically, for each and every project, you must determine the likely cash flow over time for that particular project, and structure a financing that takes into account that available cash flow. Equally important today is the accounting treatment of such asset investment. This can really complicate matters.

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The forms of financing range from (1) all equity – an energy company, puts up 100% of the money required to build a facility, keeps it on its balance sheet and operates it – to (2) part equity, part nonrecourse financing – where the energy company puts up a portion of the money required (say 20-40%) and borrows the rest, securing the loan with the cash flow from the facility – to (3) lease financing, which is functionally all debt – wherein a passive investor puts up equity and nominally owns the project, a lender puts up the rest of construction cost as debt and the project is leased to the energy company to operate, and pay off the investor and lender via rental payments out of project cash flow. There are, as you might imagine, endless variations and permutations of these three basic structures.

Q. From a project economics standpoint, are there certain factors that are relevant no matter which financing option is pursued?

A. All the financing and accounting possibilities are ultimately driven by stark reality – how much money will it cost to build the project, and how much net revenue will the project generate from operations. Entities that put up money – whether as debt, passive equity, or strategic equity – all want their money back. There are very few charitable institutions operating in this area (and even the ones that do want their money back). Therefore, it must be demonstrated that there is a reasonably good possibility that the project will return the amounts invested in its construction. The relative probabilities of success involved – the risk – translate into the "cost" of the money invested in the project – "interest" on debt, or "return on investment" for equity. In other words, the more risk, the higher the cost of financing. An investor

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must weigh all the factors involved – cost of the project, cost of operations, expected revenue, market outlook, regulatory environment, cost of financing, the project's accounting impact on the investor's balance sheet (that will affect the financing costs for other of the investor's projects), and alternative investment opportunities, just to name some – and come to a decision that this particular asset will generate a sufficient return to justify the risk of investment.

Q. Do the people providing financing compare the economics of one project with others?

A. Certainly. Energy companies must decide where to invest their finite resources. If a project is projected as uneconomic – because revenue projections are too low, operating costs or construction costs are too high, the operating environment is too risky (transmission or fuel constraints, regulatory issues etc.) – then a company will – must – chose to pass the project by and invest elsewhere. The same is true for lenders and passive investors – if the risk is seen as too high for the return (i.e., "interest") that can be borne by the project, then the money will go to some other project, or some other area. Money is fungible – investment seeking return. Energy is now a commodity. In a commodity business, the low cost producer wins, and the high cost producer goes out of business (or doesn't get into the business in the first place). That means that all costs are relative. Investors will only finance a project if they believe that the project can compete effectively in the marketplace.

Implications of Mitigation Requirements

Q. Generally, how do regulatory requirements affect financing of power projects?

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A. All projects, of course, must meet local, state and federal regulatory requirements. All expenses necessary to meet such requirements are costs integral to the project, and are line items summing to the final cost of construction, or of operation. As such, regulatory expenses are ultimately no different than any other necessary expense – a cost. All costs must be paid for – financed, in one way or another. If a particular project has an unusual regulatory requirement it must satisfy, it's an additional cost. Viewed from a strictly financing perspective, it is all cost, and impact on return. Any particular project will have to compete against other projects for sales revenue, and other projects, and the economy as a whole, for investment dollars. Expected net revenue (expected revenue minus expected costs) must be positive, and must meet or exceed the expected returns from the company's marginal investment decision. Any cost affects this equation.

Q. Some people seem to think that these power projects are so profitable the owners can afford to spend 10's or even 100's of millions of dollars on environmental programs. Is that true?

A. This is just not the case – fortunately for me, since if all projects were unrestricted money machines, no one would need investment bankers to stitch together the necessary parties to finance one of these things. The power market is very competitive. Power facilities are often dispatched – are given orders to run by the central power system administrator – based on the relative cost of power from such plant. A facility's place in this cost ranking queue would determine the amount of time it operates – and, therefore, the amount of revenue it would generate for its

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investors. This ranking process is quite competitive, and position is often determined by very small differences in relative cost of production.

Q. In this case, even though this project is in Washington, SE2 has proposed to comply with the "monetary path" of Oregon's greenhouse gas program. Do you believe that it will still be possible for SE2 to obtain financing for the project?

A. Frankly, I wouldn't know until I take a hard look at the financial projections for the project. For example, lenders analyze a project, in part, by examining the coverage ratio of the project – a comparison of the yearly net operating cash flow to debt service. A healthy project would have an minimum coverage ratio of above 1.25 to 1. To the extent you increase costs, and therefore borrow more money, to finance such costs, you naturally increase the denominator of the coverage ratio – yearly debt service – without increasing the numerator – net operating cash flow. As a result, the coverage ratio decreases.

If you are talking $5-10 million out of a $400 million project, all other things being equal – this would degrade the coverage ratios between 2 and 4%. In the abstract, this would appear to remain in the realm of the possible, but it would not be an insignificant consideration. Of course, the particular cost would have to be considered in the context of other costs, including any other environmental mitigation requirements that were unique to a particular project.

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Q. Well, presumably projects in Oregon get financed, so why is that?

A. One of Lyndon Johnson's favorite responses to political questions was "all politics is local". To paraphrase, in our business, all power generation is local. Local cost considerations, deregulation process, transmission access, fuel access, taxation scheme, competition, etc., all factor into the expected net revenue that can be generated by a specific site in Oregon versus one in Washington; this in turn translates into the comparative ability to finance a facility at such a site in Oregon versus financing a facility in Washington.

Q. If SE2 were ultimately required to pay much more in funding for greenhouse gas offset projects, would that make the project impossible to finance.

A. Again, all costs matter. As a project's costs increase, its return to investors, and ability to cover debt, drops. At some point in every project, projected costs can be increased to a level where the project cannot compete sufficiently to attract financing. I don't know enough – it is really impossible to know enough now – but, in general, for a project for which the projections are currently reasonable, but not robust, a major increase in cost could certainly render the project unable to be financed.

END OF TESTIMONY

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